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In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 1171

BIRCH RANCH AND OIL COMPANY, A CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Tax Court (R. 82–108) is unreported. The opinion of the Circuit Court of Appeals (R. 238–241) is reported at 152 F. 2d 874.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered January 9, 1946. (R. 241–242.) Petition for rehearing was denied February 13, 1946. (R. 242.) The petition for a writ of certiorari was filed on April 30, 1946. The jurisdiction of this Court is invoked under Section 240 (a) of the

Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Petitioner owned a ranch and was also interested in several other business enterprises. The Tax Court found that petitioner maintained a separate set of books for the ranch and kept them on the cash basis, although its books for its remaining activities may have been on the accrual basis. In connection with the ranch petitioner had undertaken to pay interest on the bonds of a reclamation district within which the ranch was located.

The question presented is whether petitioner may deduct $100,800 which accrued as interest on those bonds in 1937 and 1939, but which petitioner in fact did not pay.[1]

STATUTES AND REGULATIONS INVOLVED

The applicable statutes and regulations involved are set out in the Appendix, *infra,* pp. 20–23.

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[1] The Tax Court found it unnecessary to pass on the contention of the Commissioner that "in view of the closely controlled corporate arrangement there was in fact no real or actual obligation outstanding against the petitioner or its property to pay the interest claimed as deductions" and the court below did not ocnsider it. (R. 38, 40–41, 102, 106–107.) The contention of the petitioner (Pet. 6–7, Br. 19–21) that the Tax Court should have been compelled to make ultimate findings of fact which were in no way material to the issue which was decided is plainly without merit. *Kelleher* v. *Commissioner,* 94 F. 2d 294 (C. C. A. 9th), does not hold otherwise.

STATEMENT

Although the basic issue is a narrow one, the facts out of which this controversy arises are somewhat extended, and were found by the Tax Court as follows:

The petitioner, a Nevada corporation, with its principal office in Los Angeles, California, was organized by Mr. and Mrs. A. Otis Birch on October 15, 1934. They transferred to it the Conaway Ranch, their interest in the Birch Oil Company (a partnership which succeeded the Menges Oil Company in 1911) and all other property belonging to them, except the bonds of Reclamation District No. 2035, certain corporate stock and other properties having a value of about $600,000. Mr. Birch had been having difficulties during the depression years in borrowing on his personal credit the moneys needed for the operation of the ranch, and the petitioner was organized for the purpose of procuring needed bank credit. (R. 83, 84, 93.)

The partners in the Birch Oil Company were Mr. and Mrs. Birch, Mr. and Mrs. B. F. Conaway, and Mr. Birch's nieces, referred to herein as the Hopkins sisters. In 1914 this partnership purchased about 13,000 acres of overflow lands situated about five miles from Sacramento, in Yolo County, California, and in the Sacramento River Valley. The lands were purchased for farming and stock raising, and came to be known as the

Conaway Ranch. Additional acreage was thereafter purchased and by 1918 the ranch contained about 20,000 acres. All purchases had been made at $35 per acre. (R. 83, 84.)

At the time of the original purchase in 1914, the Sacramento and San Joaquin Drainage District, created under the laws of California, had started a flood control project which called for the acquisition of a by-pass across the Conaway Ranch, for the passage of excess flood-waters of the Sacramento River and its tributaries. The by-pass was then being surveyed, and it was expected that about one-half of the Conaway ranch would be taken for that purpose. The Reclamation Board of California informed Birch Oil Company that if the latter would construct a levee across its ranch property, adjacent to the by-pass, an assessment would be made against all the lands in the Sacramento and San Joaquin Drainage District to pay that company for flowage rights through the by-pass and for the construction of the levee. It expected to receive $25 an acre for the acreage used for the by-pass. Such acreage, according to law, could not be fully reclaimed and was suitable only for grazing. (R. 84–85.)

Desiring to reclaim and develop the lands comprising the Conaway Ranch, the Birch Oil Company, in 1918, filed a petition with the Board of Supervisors of Yolo County, California, for the creation of a reclamation district which would

include the Conaway Ranch and other land not owned by the Birch Oil Company or its members. In April, 1919, the establishment of Reclamation District No. 2035, comprising most of such land, was approved by the Board of Supervisors. (R. 85.)

Organization of the district was completed and the County Board of Supervisors appointed trustees for the district who, in June, 1919, employed an engineer and directed him to prepare plans for the reclamation and irrigation of lands in the district, with estimates of the cost of the necessary improvements. In a proceeding brought by the trustees to determine the legality of the district, the Superior Court of California for the County of Yolo, in June, 1920, entered its judgment that Reclamation District No. 2035 is "a duly and regularly organized and legal Reclamation District". In the same month, the trustees approved the plans submitted by the engineer and his estimate of $2,264,740 as the cost of the improvements. The plans submitted called for the construction of the main levee along the edge of the Yolo By-pass, as above described. After these plans were approved by the California Reclamation Board and the Board of Supervisors, commissioners were appointed to assess the value of the benefits to the lands in the district from the improvements contemplated and to apportion the cost of the improvements according to the benefits that would accrue to each tract of land. There-

after, and prior to July 2, 1924, the commissioners made such assessment and apportionment, the assessment was approved by the Board of Supervisors, and the list of assessment was filed on July 23, 1924, with the County Treasurer of Yolo County. (R. 85–86.)

The Birch Oil Company, under the direction of the district's engineer, built the improvements called for in the reclamation plan and financed all the costs, which were slightly in excess of $2,000,000. The work was substantially completed by 1925 and Birch had then acquired individually and at undisclosed costs seven of the eight parcels of land which, with the Conaway Ranch, comprised the land of the district. The parcel not so purchased consisted of 240 acres. (R. 86–87.)

In the meantime, the Hopkins sisters, being desirous of disposing of their interests in the Conaway Ranch, by agreements dated January 1, 1924, sold such interests to Mr. and Mrs. Birch for $787,000, an amount designed to pay them their proportionate part of the Birch Oil Company funds invested in the ranch. Under the agreements each of the sisters agreed to accept bonds of Reclamation District No. 2035 of $393,000 and cash in the sum of $500. Birch and his wife agreed to cause the district to issue bonds in an amount of at least $800,000, which were to constitute a prior lien on all of the property in the district. Birch and his wife were to have immediate and absolute posses-

sion and control of the properties acquired from the Hopkins sisters and were to be entitled to all rents and profits and were to assume all liabilities and burdens incident to the ownership thereof. The bonds not having been issued at the time of the agreements on January 1, 1924, Birch gave each of the sisters his promissory note in an amount equal to the amount of the bonds she was entitled to receive under the agreements. (R. 87–88.)

According to the minutes, the landowners, at an election held on August 28, 1924, voted to issue bonds to pay for the reclamation work which had been done, and on October 26, 1924, the trustees adopted resolutions providing for the issuance of bonds. (R. 88.)

On January 5, 1925, the trustees of the district adopted resolutions directing that the district pay Birch and Conaway $2,000,000 for moneys advanced in the construction of the improvements. On the same day Warrant No. 1 for $2,000,000, drawn on the Treasurer of Yolo County, was issued to Conaway and Birch but was not paid for want of funds. (R. 88–89.)

On January 7, 1925, the trustees of the district delivered to the County Treasurer bonds of the district totaling $2,264,740. The bonds bore interest at the rate of six percent per annum until paid and were in denominations of $1,000. The first $227,000 thereof were to mature on January 1, 1935, with a like amount maturing on January

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1, of each year following until January 1, 1944, when the bonds then remaining and amounting to $221,740, were to mature. Also on January 7, 1925, the County Treasurer gave notice that on January 23, 1925, he would sell Bonds Nos. 1 to 2,000, inclusive, of $2,000,000 par value, to the highest bidder. Birch, acting for himself, Mrs. Birch and the Conaways, was the highest bidder, his bid being $2,000,000 plus accrued interest. Being the highest bidder he became the purchaser of the bonds and gave in payment therefor Warrant No. 1 of the district, which had been received by him and Conaway in payment for the building of the improvements for the district. (R. 89.)

In a proceeding brought by the trustees of the district, the Superior Court of California for the County of Yolo, on March 2, 1925, entered its judgment "that said bonds are a valid legal obligation of said Reclamation District No. 2035." (R. 89–90.)

Upon receipt of such bonds Birch delivered to each of the Hopkins sisters $393,000 par value of such bonds, or a total of $786,000, pursuant to the agreements of January 1, 1924. Upon delivery of the bonds, and in return he received the notes covering the purchase price of their interests in the ranch. At the same time the Hopkins sisters made formal conveyance to Birch and his wife of all their interest in the Conaway Ranch. (R. 90.)

At or about the same time the Hopkins sisters granted to Birch and his wife the right to pur-

chase the bonds received by them as above set forth. According to these agreements, Birch and his wife agreed to purchase at face value the bonds in question, the purchases from each sister to be made in installments as set out in the agreement. (R. 90–91.)

In 1926 Birch entered into an agreement with the Conaways for the purchase of their interests in the ranch and in the bonds of Reclamation District No. 2035. The purchase price was paid in cash and in installments. (R. 92.)

Beginning with January 1, 1926, the first installment date under the agreements of January 10, 1925, the Hopkins sisters elected to sell the bonds to Birch and his wife pursuant to the terms of the agreements. Birch and his wife made the payments on the bond purchases as called for in the agreements until the early 1930's, when, due to the depression and a resulting lack of funds, they were unable to make the further payments on the dates prescribed, and extensions of time have thereafter been allowed. The bonds paid for in the face amount of $476,000 were delivered to Birch and his wife. The Hopkins sisters still hold the remaining $310,000 of the bonds. (R. 92.)

Beginning in 1925, up to and including 1934, Birch and his wife formally paid over, for the Conaway Ranch, $120,000 per year for disbursement as interest on the bonds of Reclamation District No. 2035. Such portion of the amount so paid as was applicable to bonds owned by Birch

and his wife was repaid to them, but, under a claim that interest on such bonds was tax exempt, the amounts so received were not reported by them as taxable income. In each of the years Birch and his wife, on their income tax returns, claimed a deduction of $120,000 as interest paid. The propriety of these deductions was questioned by the Bureau of Internal Revenue for practically every year, but in each instance the deduction was ultimately allowed. (R. 93.)

Birch and his wife organized a second Nevada corporation on October 15, 1934. This was a holding company known as Birch Securities Company. To that corporation they transferred $1,594,000 par value of the reclamation bonds, being all of the bonds of the district except the $310,000 still in the hands of the Hopkins sisters and those held by an insurance company and Lula M. Minter. In addition, they transferred to the Securities Company the corporate stocks referred to above. (R. 94.)

Birch and his wife also organized on October 15, 1934, a corporation known as the Birch Holding Company, and transferred to it the stock of the petitioner and that of Birch Securities Company. (R. 94.)

At the time of its organization or on some date thereafter, the petitioner guaranteed performance by Birch and his wife of their contracts of January 10, 1925, with the Hopkins sisters. (R. 95.)

After its organization and for each of the years 1935 and 1936, the petitioner continued the practice of Birch and his wife paying over $120,000 for disbursement as interest on the $2,000,000 of bonds of Reclamation District No. 2035. But, beginning with 1937, no amount has been paid in any year by the petitioner as interest on the bonds transferred by Birch and his wife to the Birch Securities Company, nor has it paid any amount as interest on the bonds held by the Great Republic Life Insurance Company. As to the bonds held by the latter, there was a dispute between that company and the petitioner over the rights in and to those bonds. They were ultimately acquired by the petitioner from the insurance company in 1940, for $65,000. For each of the fiscal years 1937 and 1939 the taxpayer did pay $600 to Lula M. Minter as interest on the bonds which had been acquired by her and also paid $18,600 to the Hopkins sisters in each of those years on their bonds. (R. 95.)

On its books for the fiscal years 1937 and 1939, the petitioner accrued $120,000, to represent interest on the entire $2,000,000 par value of the bonds of Reclamation District No. 2035. For the fiscal year 1937, it entered the $18,600 paid to the Hopkins sisters, as above stated, as a loan to Birch Securities Company and that company treated the sum as a loan from the taxpayer and charged a net of $17,382.75 as interest paid to the Hopkins sisters. It claimed a deduction on its

income tax return for that year in the latter amount. (R. 96.)

At no time has any amount been paid into Reclamation District No. 2035, or set aside by Birch and his wife or the petitioner for the purpose of paying off the bonds of the district, even though the bonds began to mature on January 1, 1935, at the rate of $227,000 per year. In November of 1934, steps were taken to refund the original bonds with refunding bonds to mature at the rate of $50,000 per annum, beginning January 1, 1945. At the time of the hearing herein, all of the original bonds had been deposited for exchange but no exchange had occurred. (R. 96–97.)

Since its organization the petitioner has operated the Conaway Ranch, devoting it to the growing of crops and the raising of sheep. The petitioner, as owner of the Conaway Ranch, has borne all of the costs and expenses of maintaining and operating the improvements of Reclamation District No. 2035 and treats such costs as a part of its expenses in operating the ranch, all in a manner which would be no different if there were no reclamation district, whether formal or actual. The district has no expense not taken care of by the petitioner. (R. 97.)

All crops grown on the ranch during a given fiscal year are sold in the same year in which grown. The herd of sheep is kept at an average of 3,500, with losses being replaced by younger

animals. All sales are made for cash, as are all purchases. The petitioner keeps a separate set of books with respect to the ranch operations. The ranch books are kept on a cash basis. For each of the taxable years involved in this proceeding the petitioner used Form 1040 F [2] in reporting income from the operations of the ranch, and reported the income or loss therefrom on a cash basis. (R. 97.)

The petitioner does not own any oil properties directly, but it does have a partnership interest in Birch Oil Company, which owns and operates oil wells. The petitioner keeps its books and files its returns on the basis of a fiscal year ending September 30, while the Birch Oil Company keeps its books on a calendar year basis. At the close of its calendar year, Birch Oil Company determines its net income for the year and the amount distributable to each partner. The petitioner, as soon as it is informed of the amount, enters that amount on its books as income as of the end of December. The amount thus entered is reported as income by the petitioner on its return for the fiscal year ending on September 30 following. (R. 97–98.)

In addition to the ranch and the interest in the Birch Oil Company, the petitioner owns a citrus grove and various rental properties, in-

[2] Form 1040 F is a form filed by farmers with their income tax return.

cluding two small farms. The income from and the expenses incident to those properties are entered on taxpayer's books as they accrue. (R. 98.)

The petitioner in its income tax returns for the fiscal years 1937 and 1939 claimed for each year a deduction of $120,000, representing the amount accrued on its books to cover interest on the bonds of Reclamation District No. 2035. In determining the deficiencies, the Commissioner allowed the deductions only to the extent of $600, being the amount paid to Lula M. Minter. (R. 98–99.)

The Tax Court held that the petitioner was entitled to deduct the $18,600 paid to the Hopkins sisters as interest in the taxable years but denied the deduction of the remaining $100,800 which had been accrued as interest on petitioner's books. (R. 101–109.)

The Circuit Court of Appeals affirmed the Tax Court's decision. (R. 238–242.)

ARGUMENT

There is no conflict of decisions and the court below correctly affirmed the Tax Court's decision determining that the sum of $100,800, whether regarded as taxes or interest, was not deductible in the taxable years 1937 and 1939 since that sum was not paid out and the petitioner's books covering the Conaway Ranch were kept on a cash basis during the taxable years.

Net income is required to be computed "in accordance with the method of accounting regularly employed in keeping the books of such taxpayer", and deductions must be taken in the year in which the sums involved are paid or accrued "dependent upon the method of accounting upon the basis of which the net income is computed". Sections 41 and 43 of the Revenue Acts of 1936 and 1938, Appendix, *infra*. The test laid down by the statute for determining whether the taxpayer is on the cash or accrual basis of accounting is what his books show and this presents a question of fact. Consequently the Tax Court's finding on such point must be sustained if supported by any substantial evidence. *Dobson* v. *Commissioner* 320 U. S. 489, rehearing denied, 321 U. S. 231; *Aluminum Castings Co.* v. *Routzahn,* 282 U. S. 92; *United States* v. *Anderson,* 269 U. S. 422.

In determining the accounting basis here, the Tax Court found in substance: (1) that the petitioner was engaged in several kinds of business operations; (2) that the interest item here involved had no connection whatsoever with any of its business except the operation of the Conaway Ranch which is located in the Reclamation District and is the property against which the assessment was made for the irrigation project; (3) that the books for the Conaway Ranch were kept entirely separate from the books for the petitioner's other business operations; and (4)

that the books for the ranch were kept on a cash basis and the income from those operations was so reported. (R. 97, 98, 103–104.) Accordingly, the Tax Court reached the conclusion that any sums accrued as interest but left unpaid during the taxable years could not be deducted in those years.

The Tax Court's findings are amply supported by the evidence. Petitioner's president testified that all of the business of the Conaway Ranch was on a cash basis, that the ranch has maintained the improvements of the Reclamation District for the use of such improvements and that it has undertaken the obligation of paying the interest on the district's bonds each year. (R. 133, 163–166.) The testimony of petitioner's secretary also shows that petitioner has several distinct business operations, that the books of the Conaway Ranch are kept separately from its other books and that the income tax return for the ranch was made on a cash basis by the ranch manager from books which he kept at the ranch. (R. 167–177, 183–184.) He also testified that the interest item here was accrued, but that cannot, of course, be the decisive factor since the evidence shows that all other items concerning the ranch were entered on a cash basis. *Niles Bement Pond Co.* v. *United States,* 281 U. S. 357, 360. A taxpayer must be consistent in making bookkeeping entries and may not treat receipts on a cash basis while it accrues

expenditures or vice versa. *Mass. Mutual Life Ins. Co.* v. *United States,* 288 U. S. 269, 273.

United States v. *Anderson, supra,* does not support the petitioner's contention that the issue whether books were kept on the cash or accrual basis presents "a clear-cut question of law." In the *Anderson* case the taxpayer contended that it had not kept its books on the accrual basis but this Court held that the taxpayer was precluded on that point by findings of the Court of Claims that it had. The case did not arise in the Tax Court and it establishes no principles with respect to judicial review of Tax Court decisions. On the merits the decision supports the Government's position since it holds that a taxpayer keeping its books and accounts on one basis may not deduct a single item on a different basis.

Petitioner's argument that there was no rational basis in the primary findings to support the Tax Court's ultimate finding or conclusion that the books were kept on the cash basis is predicated on an erroneous statement as to the primary findings of fact. The Tax Court did not find, as stated, that petitioner entered on its books of account every item of accounts receivable and payable as the same accrued, including the only accrued item which concerned the ranch. (R. 98.) What it did find was that the taxpayer owned certain other properties, and the income from and expenses incident to those properties were entered on the petitioner's books as they accrued. (R.

98.) The material finding here is that the petitioner kept a separate set of books with respect to the ranch and the ranch books were kept on a cash basis. (R. 97, 103.)

As previously pointed out, the evidence clearly supports these findings. Whenever different business operations of a taxpayer are separated into distinct units, as in this case, the particular item involved must be treated as required by the accounting method used for such unit. *Cecil* v. *Commissioner,* 100 F. 2d 896 (C. C. A. 4th); *Stern* v. *Commissioner,* 14 B. T. A. 838, 843. The petitioner cites no authority to the contrary. Moreover, in the *Dobson* case, *supra,* the Supreme Court pointed out that (pp. 501–502) "Whatever latitude exists in resolving questions *such as those of proper accounting* * * * exists in the Tax Court."

There is no issue here as to statutory interpretation. Consequently this case is unlike *Security Mills Co.* v. *Commissioner,* 321 U. S. 281, on which petitioner relies. In that case the taxpayer, admittedly on an accrual basis, argued that a contested liability, even if not properly accruable in the year when the liability arose, should nevertheless be deducted on the ground that the statute authorized a departure from the general rules governing deductions when observance of the regular annual accounting period would distort income. Thus it was necessary there to consider the meaning of the statutory provision covering ex-

ceptions to the general rule and as this Court decided that the taxpayer's interpretation of the law could not be accepted, the deduction was denied. The issue here is clearly different.

CONCLUSION

The decision of the court below is correct and presents no conflict with other cases. The petition for a writ of certiorari should be denied.

Respectfully submitted.

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MAY 1946.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this title.

(c) *Taxes Generally.*—Taxes paid or accrued within the taxable year, except—

* * * * *

(4) taxes assessed against local benefits of a kind tending to increase the value of the property assessed; but this paragraph shall not exclude the allowance as a deduction of so much of such taxes as is properly allocable to maintenance or interest charges.

* * * * *

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed

does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year. (For use of inventories, see section 22 (c).)

SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the dividends paid credit provided in section 27) provided for in this title shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

The corresponding sections of the Revenue Act of 1938, c. 289, 52 Stat. 447, contain the same provisions as those above.